I. Introduction

A. Purpose and intended users

This white paper is intended as a tool for regulators to research methods for combating and preventing escrow theft, title insurance theft and other forms of fraud associated with title insurance and closing services transactions. It is important to recognize regional differences in the way title insurance and closing services are provided and regulated. There are few one-size-fits-all solutions. Nor, is there a single solution to the problem for any particular jurisdiction. Therefore, a variety of methods are identified. Where practical, this paper will attempt to discuss the merits as well as the shortcomings of each identified method. The availability of proprietary solutions such as software and systems approaches will also be discussed without identification of specific providers. The ultimate goal of this paper is to identify ways to improve title insurance and closing service consumer protection.

The white paper may also be used by the title insurance and closing services industry when evaluating their own enterprise risk management and auditing guidelines for combating escrow and title insurance premium theft. These are problems that cause a great deal of expense for insurers, in terms of claims, auditing, legal fees and mopping up resulting failed title agencies. In addition to direct monetary costs, the potential for reputational damage or even resulting insolvency is a major concern. Because of the unpredictability of the frequency and magnitude of these events, serious negative results to title insurers’ financial condition can result. The unnecessary and hopefully preventable expenses associated with mishandling of title insurance and closing funds are ultimately borne by customers in the form of higher title insurance premiums and closing costs.

II. Understanding Fraudulent Actions and Schemes Against Title Insurers

A. Background and Definition of the Problem

i. Title insurance and closing services have historically been a labor-intensive process with few opportunities for centralization of services within an insurer. Although direct services have grown due to increased availability of digitized courthouse records, insurers rely on a large number of licensed and unlicensed individuals who are not directly employed by the insurer for title searches, issuance of commitments and policies, handling of funds, providing closing services and post-closing services. This decentralization, along with the large number of individuals and large number of financial transactions increases the opportunities for those that decide to operate in a dishonest or untrustworthy manner. An oft repeated urban legend recounts a newspaper reporter asking gangster Willie Sutton why he robbed banks, with the answer being, “because
that’s where the money is.” Although the legend is not authenticated, that purported response could be one reason why so many cases of escrow account and title insurance premium misappropriations have taken place. In some cases, cash strapped title company owners begin juggling or floating entrusted funds to cover operational costs with the hope of being able to catch up at a later date. This inappropriate use of funds that belong to others eventually catches up with the tile company, resulting in a defalcation. One thing is clear, however. The vast majority of title insurance producers and closing professionals are honest and service-oriented individuals who are devoted to providing an excellent outcome for their customers. The few individuals who do misappropriate or mishandle customer and insurer funds generate a disproportionate amount of problems. Some problems can and ought to be detected and reported by vigilant co-workers who notice irregularities. Regulators can help reduce the number of misappropriations by periodic or random audit of title companies, however the large number of licensed title companies and title producers make wide scale audits an impractical and economically unfeasible task for most states.

ii. Escrow and title insurance thefts harm consumers in a number of ways. The most obvious example of loss to consumers is instances where customer funds are outright stolen without recourse from responsible parties such as insurers. In some instances, closing services and title insurance are handled by separate entities, thereby reducing the likelihood that any specific title insurer will be responsible to step in and reimburse for loss of escrow funds. Escrow funds subject to loss could be pre-closing funds such as down payments or post-closing funds intended for disbursements necessary to clear the title. Theft of title premium frequently means no title policy is issued and the consumer does not get what he or she paid for. Since many customers don’t know exactly what to expect after closing, they may not be alarmed at not receiving a title policy. When lenders complain about not receiving a policy, the offending title company resorts to the “squeaky wheel gets the grease” method of prioritizing which policies get issued. Failure by the title company to pay off certain escrowed funds, may not surface for years or until the property is resold.

iii. Escrow, settlement fund and title insurance premium theft also harms title insurers. Reputational damage, loss of revenue, resulting claims, regulatory responses and costs associated with remediation are all adverse effects of this
problem. Additionally, title insurers increasingly must expend a great deal of resources to detect, prevent and combat problems associated with these types of losses. Insurers can exercise more “hands-on” control, policies and procedures for reduction of these problems with direct operations. Independent agent arrangements make surveillance and management more complicated. Most large title insurers operate with a combination of both direct operations and independent contracted agents. In most jurisdictions, closing services are also commonly performed by attorneys. This also complicates insurers ability to obtain records to detect and prevent escrow and settlement problems.

Methods by which closing funds and title insurance premiums can be misappropriated are numerous. Some of the potential methods include:

1. Misappropriation of closing funds for use other than as provided for in the closing instructions.
2. Misappropriation of title insurance premium with failure to report and issue title insurance policies.
3. Knowing participation in fraudulent real estate transactions including falsification of documents or knowing acceptance of false documents.
4. Failure to perform all services specified in the closing instructions or HUD form.
5. Fraudulent activity by unlicensed or unauthorized entities.
6. Sales of products or services which purport to be title insurance or to replace title insurance but do not.
7. Engaging in check-kiting or other banking-related fraudulent schemes.
8. Acceptance of funds that are not “good funds” for the purpose of closing transactions.
9. Misrepresentation of title defects or failure to disclose title defects with the intention of burdening the title insurer with subsequent losses.

B. Types of Escrow Theft
   i. Misappropriation of escrow funds for fraudulent purposes
   ii. Mingling of escrow/operational funds
   iii. Inappropriate investment of escrow funds (unsound/non-guaranteed accounts)
   iv. Delays/failures in issuing title policies and premium remittance
   v. Misappropriation of title insurance premium
   vi. Failure to fulfill closing obligations (deed filings)
   vii. Participation/complacency in mortgage/real estate fraud
   viii. Check kiting
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

ix. Inadvertent mishandling resulting from confusing or poorly written closing instructions

x. Fraud schemes against title insurers and warning signs
   1. Flipping and flopping
   2. Phony appraisals
   3. Rushed escrow closings

Xi. Cyber-fraud committed by unrelated parties aimed at identity theft, obtaining fraudulent remittances or misdirection of funds.

Should we include info on the recent FinCEN Report?

C. Gaps in Insurance Laws/Regulations

Summarize and include Appendix of State Laws Related to Model #230 and #628

What else?

NAIC Model Law #230, “Title Insurance Agent Model Act” and Model Law # 628, “Title Insurers Model Act” each contain provisions that can assist in preventing escrow and title insurance premium theft and mishandling. Model # 230 and Model #628 were not widely implemented by the states, although many states have laws which contain components of the two models.

Among other requirements, the NAIC Title Insurance Agent Model Act includes provisions that address:

- Licensing requirements
- Fidelity coverage or acceptable alternatives other than closing protection letters
- Examination of title insurance agents by the insurance department
- Required provisions for underwriting contracts with the title insurer
- Termination provisions
- Rendering of accounts to the title insurer
- Fiduciary accounts for funds owed to the title insurer
- Insurer access to records and accounts
- Separation of records for different title underwriters
- Timely submission of escrow and title claims
- Maintenance of an inventory of policy forms or numbers
- Statements of financial condition of the title insurance agent
- Fiduciary trust accounts in a qualified financial institution for escrow and settlement funds
- Disbursement of funds only pursuant to written directions
- Good funds requirements
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

- Independent audits of escrow, settlement, closing and security deposit accounts, and
- Record retention requirements.

Similarly, among other requirements, the NAIC Title Insurers Model Act includes provisions that address:
- Closing or settlement protection
- Direct operations
- Requirements to have agents’ financial condition statements on file
- Annual on-site reviews of agents
- Notification of appointments and termination of agents
- Policy form or policy number inventories
- Proof of licensing
- Requirements of maintaining escrow and security deposits when the insurer operates as a closing agent, and
- Record retention requirements.

Although not comprehensive, the provisions of these two NAIC models can provide added protection against mishandling of escrow, settlement funds and title insurance premiums. Many of the provisions mentioned here are discussed in more detail within this paper. For jurisdictions that have not adopted NAIC Model Laws # 230 and # 628, but wish to incorporate specific provisions intended to address proper handling of escrows and title insurance premiums, the models can be a source for legislative language. A list of jurisdictions that have adopted each of the models’ language or related provisions is located in the NAIC’s compendium of model laws.

It is important to keep in mind that gaps exist, even with the model law requirements. Protection for closings performed by entities not contracted with the selected title insurer are a common exception.

III. Potential Tools and Methods to Address Escrow Theft

This should include a balanced perspective including pros/cons and effectiveness of the different approaches. This section may also include information on which states currently regulate escrow, how they regulate it, and the effectiveness of that regulation.

A. Addressing Escrow Theft at the Licensing Stage
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

[From Carrie Yavul]
Preventing escrow theft should begin at the most basic level of regulation - licensing. Licensing standards should be at a level commensurate not only with the licensee’s level of involvement with an escrow account but also with their level of involvement with the insurance product itself. For the purposes of this paper the focus is on the licensee’s level of involvement with an escrow account.

The amount of money which potentially moves through a title agent’s escrow account is considerable. This can make title agency ownership/employment attractive to those who either start out with intentions of escrow theft or to those who find themselves in a situation from which escape seems possible by escrow theft. Justin Ailes suggests changing previous sentence to: This can make escrow theft tempting to those who find themselves in a situation where they perceive an ability to misappropriate escrow funds without being discovered. Consideration should be given to setting licensing standards which can make the barriers to entry high enough that the profession is less attractive to those whose intentions are simply to be a title or escrow agent for access to large amounts of money but not so high as to discourage growth and expansion in the industry when economic conditions encourage it. Standards vary across the states from requiring escrow agents to be licensed with Departments of Financial Institutions to not requiring a license at all.

States have taken different approaches to monitoring agents’ handling of escrow funds. Some states require agents’ escrow accounts to undergo an audit by a CPA which is then submitted to the department of insurance. Some states require underwriters to perform audits of their agents’ escrow accounts and other states employ examiners or auditors to conduct their own reviews. Consideration must be given to the burden that the cost of compliance will place on states and agents. As an example, CPA audits of escrow accounts can be costly to the title agent. States should also consider the staffing requirements of reviewing the submitted audit reports and determining compliance with the requirement.

Another consideration might be to require licensees to maintain escrow accounts or funds held in trust in clearly identified accounts with approved banking institutions and/or banking institutions that offer Positive Pay. Under a Positive Pay system an Agent transmits a list of the checks that it has issued each day to the bank. Then the bank matches that list with the checks that are presented on the Agent account for payment. Only checks, appearing on the submitted list, will be honored for payment. If the check is not on one of the lists, the bank will advise the agent and, unless the agent gives authorization the check will not be honored.

In some states, attorneys are required to maintain their Attorney Trust Accounts with approved banks, such as is suggested here. Additional requirements on the banks which hold such accounts require the bank to report to the state’s disciplinary commission when an Attorney Trust Account is over drawn. This is another avenue states can explore with regard to title agency escrow accounts as well as requiring the title agency to register their banking account information with the licensing authority.
Another approach is to consider requiring a separate license designation or separate license altogether for individuals who handle escrow funds versus those who simply sell title insurance but do not handle escrow transactions. If these functions are separated by licensing designations the educational requirements for individuals who handle escrow transactions could be more focused on proper account balancing techniques and theft prevention. Pre-licensing and continuing education requirements for license renewals can and, perhaps, should focus more intensely on proper escrow accounting procedures and how to better spot the red-flags which could indicate a co-worker, agency owner or employee is misappropriating escrow funds. This can be done regardless of the state’s approach to handling the licenses.

A potential complication to separate licensing for escrow handlers could lay where states require agency/firms to be licensed but not report to the licensing authority a list of their employees. In order to determine which individuals were performing escrow handling functions for which agencies it would be prudent to require agencies to report a list of their employees and maintain the list with the licensing authority. This would be done so that, should a potential problem arise, the potential individuals responsible could more easily be identified.

Some states also require agents/agencies to maintain a fidelity bond and errors and omissions insurance. In addition to these, a simple background check of license applicants could reveal potential problems before they have a chance to operate and have access to escrow funds.

Any changes to licensing requirements must take into account the costs associated. For instance, any requirement upon an agency to report more information to the licensing authority could result in a cost and any cost to an agency could, ultimately, result in a cost to the consumer. Similarly, when an industry is required to report information to a licensing authority the licensing authority will have to audit the information for compliance and accuracy. This requirements result in higher costs to the states in terms of personnel and time required to conduct the audits and carry out any administrative actions required as a result of non-compliance.

[From Marty Hazen – edited to remove KS references]

Some states only license the insurance agents in a title agency – the closing professionals are not required to be licensed or have any CE. Requiring some sort of examination, licensure and CE could be a valuable tool, but would probably require statutory changes to do so.

Some states require a separation of escrow from title insurance. The account is to be a “separate fiduciary trust account” wherein the funds are segregated in a manner that permits the funds to be identified on an individual basis.

Enhanced bonding/surety requirements are required by some states. Title agents may be required to have an escrow, settlement or closing accounts bond or irrevocable letter of credit in varying amounts. These amounts may need to be adjusted periodically.

Minimum capitalization requirements for agents could be required.
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

Enhanced requirements for underwriter-agent contracts could be a method to make an agent responsible for escrow theft on a contractual basis. Currently, this may be unclear in the contract.

Enhanced initial audits of agents/agencies by underwriters would be a sound business practice on the part of an underwriter, and would potentially enable them to weed out potential problem agents prior to contracting with them.

B. Addressing Escrow Theft During Active Business Operations

[From David Barney]

Independent Audits Overview

On an annual basis, independent audit laws and regulations may require title insurance agents or agencies that handle escrow, settlement, closing, or security deposit accounts submit a filing to their regulator which would require an independent review of its escrow, settlement, closing, and security deposit accounts. Independent audits of title agents’ depository accounts can be a useful tool for regulators to monitor to determine if title agents are performing best practices within their agency. In addition, these audits provide useful data to the regulator that may indicate that a problem exists or an early warning sign of potential problems within the accounts. Statutory guidelines for the completion of the audits ensure the audits are completed in a timely and concise manner. In addition to the audit, the filing would require supplementary information to be submitted to the regulator. The following sections will provide additional information regarding the requirements/guidelines of the independent annual audit in addition to any regulator follow-up that may be needed in response to the audit.

Exemption Defined

In certain instances, a title agent may be exempt from filing an independent audit if they don’t handle escrow funds, if they only handle a small number of transactions per month and/or if they had an audit by one of their underwriters. In lieu of the independent audit, the agent may be required to complete and submit an exemption form, in addition to any supplementary forms to the regulator.

Required Filing Forms for Supplementary Information

Every title agent and agency may be required to complete necessary forms as a part of their annual filing. The form contains data fields for information that would be useful to the regulator. Possible information that can be collected by the regulator is listed below:

1. Agent/Agency Contact Information
   a. Name
   b. National Producer Number
   c. Business Contact Information
   d. Residential Contact Information
   e. Preferred Mailing, E-Mail and Phone
2. Supplementary Insurance Information
   a. Errors and Omission Insurance Coverage
   b. Surety Bond Coverage
3. Depository Account Information
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

a. Listing of all depository accounts used by agent/agency
   i. Name of Account
   ii. Account Type (Directed Funds, IOTA, Non-IOTA, Premium Trust, Operating, Other)
   iii. Account Number
   iv. Depository Institution and Address
   v. Date Opened and Closed

4. Determination of Filing Status
   a. Questions to Determine Status
      i. Do you handle funds that are required to be deposited into an Interest on Trust Account (IOTA) in your name?
      ii. If yes, have you had an audit by one of your underwriters?
      iii. Provide name of underwriter that completed audit.
      iv. Did you average five or less transactions per month during the review period?
   b. Exempt Status
      i. Handle funds that are deposited into an IOTA which isn't in your name.
      ii. Handle funds that are deposited into an IOTA which is in your name AND one of your underwriters completed an audit on your IOTA AND you average five or less Ohio transactions per month.
   c. Non-Exempt Status
      i. If the agent is not exempt, they required to submit an Independent Annual Review.
      ii. Must be completed by a Certified Public Accountant (CPA).
      iii. Must include a copy of the CPA Report of the Agreed Upon Procedures as outlined in the laws, rules and/or regulations

5. Agent/Agency Explanations
   a. All findings in the CPA Report should be fully explained.
   b. All other issues in the filing should be explained.

Independent Annual Review
An Independent Annual Review (IAR) of an agent’s escrow, settlement, closing, and security deposit accounts must be completed by a Certified Public Accountant. In addition to being a CPA, the independent reviewer of the account shall be qualified in the following manner:

(1) The independent reviewer may not be an employee of a title insurance company nor may the reviewer be an employee of or hold an ownership interest in:
   (a) The business entity being reviewed,
   (b) In any affiliates of the business entity being reviewed,
   (c) In any owners of the business entity being reviewed, or
   (d) Any financial institution or its affiliate in which one or more escrow accounts subject to review under this rule are held.

The IAR can be based upon agreed upon procedures as defined in the “Statements on Standards for Attestation Engagements” issued by the “American Institute of Certified Public Accountants”. Where no exceptions are found as a result of applying the procedure, the statement “no exceptions” should be noted. Where a procedure cannot be completed because the
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

required information is unavailable, the statement “information unavailable” should be noted and explained in detail. The procedures can include, but are not limited to the following:

(a) Obtain from the agent a listing of all agent depository institution accounts existing at any time during the review period, including operating and other non-fiduciary accounts
   (i) Report as specific findings all non-IOTA escrow accounts
   (ii) Report as a specific finding all non-IOTA escrow accounts in which any interest, in the form of cash or earnings credits, is retained by the agent.

(b) Test the agent’s three-way reconciliations
   (i) Foot reconciliation and any supporting schedules;
   (ii) Compare depository institution balance per reconciliation with depository institution statement
   (iii) Compare book balance per reconciliation with control account such as check book balance
   (iv) Compare reconciled balances to the open escrow trial balance of the same date
   (v) Review the agent’s open escrow trial balance for the two monthly periods.
   (vi) Verify deposits in transit
   (vii) Verify outstanding checks by tracing to the subsequent month’s depository institution statement.
   (viii) Report the amount and the agent’s description of other reconciling items
   (ix) Verify the agent has avoided checks procedure.

(x) Determine the timing of the preparation of the three-way and depository institution reconciliations for each of two months tested.
(xi) Review the escrow depository institution account statements for the sample months for the presence of negative daily balances, if provided on the statement, and depository institution charges for non-sufficient funds or overdraft charges.
(xii) For each escrow account, select a haphazard sample (as defined in the “American Institute of Certified Public Accountants Audit Sampling Guide”) of twenty canceled checks and/or outgoing wire transfers per month for the sample two month periods and report the following:
   (a) Checks or wire transfers one thousand dollars or greater payable to the agent or to its affiliates or owners which do not correspond to fee amounts reflected in the documents in the related file
   (b) Checks or wire transfers with no file reference
   (c) Any checks on which the check date is more than sixty days prior to the depository institution clearing date
   (d) If canceled checks or images of checks are available, endorsements not consistent with the payee and/or alterations to canceled checks.
   (e) Checks signed by other than authorized check signer
   (c) List all states for which the agent conducts settlements
   (d) Have the agent complete and certify the annual review supplementary form as prescribed by the superintendent for listing required insurance coverage information

Independent Review Findings
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

As a result of an IAR, findings and/or exceptions may be identified by the CPA. Findings can be a useful tool for a regulator to help determine if there are any inconsistencies in title agent’s depository accounts. Since the CPA only performs testing on a sampling of data from the compliance period, a finding should be further evaluated by a regulator to determine if a larger problem exists. The following findings should be further evaluated by a regulator:

1. Three way reconciliation not completed by agent
2. Negative escrow trial balances
3. Other reconciling items
4. No voided check procedure
5. Checks or wire transfers to the agent that don’t correspond with closing file
6. Outstanding checks over 30 days
7. Deposits in transit over 30 days
8. Negative daily balance in escrow account

When an agent submits their filing, they have the opportunity to provide an explanation for each finding/exception that was identified. While an explanation may be useful to determine the extent of a potential problem, further evaluation may need to be completed. Quite often, a title agent may need to provide to the regulator a more detailed explanation, copies of bank statements, closing files and other documents in order to fully determine if a larger problem exists.

[Other possible topics to address]

- Ensure market conduct examinations include escrow practices
- Enhanced escrow account requirements
  - Mandatory use of trust accounts
  - Standards for trust accounts, permissible investments and prohibitions on sweeping accounts
  - Dual signatures for all accounts
  - Use of bank accounts which automatically alert regulators of overdrafts
  - Discuss rules surrounding use of master trust accounts for escrow funds
- Regulatory policy fees (i.e. Indiana)
- Enhanced financial standards for agents
- Mandatory/enhanced reporting requirements (whistleblower immunity statutes)
- Applicability of general insurance fraud prevention laws to title/escrow
- Good funds requirements
- Requirements for agent/underwriter records availability
- Coordination among States through NAIC mortgage fraud prevention working group
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

- Regulator and underwriter monitoring for warning signs of potential problems
- Enhanced agent fiduciary standards/accounting safeguards
- Timeliness requirements for policy issuance
- Dialogue with lenders to enhance early warning of slow policy issuance or other suspicious activity
- Coordination with banking, real estate, and other state and federal regulators
- Guidelines on agency ownership and affiliated business
- Enhanced underwriter monitoring of escrow accounts
  - Centralized order reporting and order management
  - Centralized escrow account reconciliation software (IT solutions)
- Improved training regarding escrow specific issues/compliance
  - Underwriter compliance personnel
  - Regulators, including market conduct examiners
  - Consider specialized regulatory staff devoted to escrow/title insurance issues
- Underwriter use and promotion of ALTA Standard Procedures and Controls for the Title Industry
- Underwriter requirements for fidelity, surety, and bonding practices
- Underwriter promotion of professional designations to achieve best practices, a standard of excellence, and a high degree of integrity
- Consumer education
  - Encourage consumers to request a CPL if available
  - Encourage consumers to work with trusted companies
  - Encourage consumers to request copy of agent’s fidelity/surety/other bonding

C. Mitigating Escrow Theft Once a Theft Has Occurred

i. Closing Protection Letters
   1. Background

[From David Cox]

Background
In many states title insurance agents or appointed attorneys conduct real estate closings as part of the process of issuing a title insurance policy. Real estate closings are often complex and are a critical step in the transfer the title of ownership of the real estate. The closing often includes escrow - the collecting, holding and disbursing of large amounts of money belonging to others. Money is typically paid by the buyer and the buyer’s lender to the escrow agent who then pays the money to the seller and the seller’s mortgage lender. The escrow agent may also hold funds to pay real estate sales agents, inspectors, appraisers and others.
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

Title insurance policies are also issued for the lease of a property in much the same way as the sale of real estate. When we use the term “buyer” we mean buyer or lessee (tenant). Likewise, when we use the term “seller” we mean seller or lessor (landlord). In some states “approved attorneys” conduct the escrow and closing instead of the title insurance agent and in this paper when we refer to “agent” we mean agent to include approved attorneys.

Closing Protection Letters (CPLs) contractually obligate a title insurer to indemnify certain parties to a real estate transaction for the improper actions of the title insurer’s agent in the conduct of closing the real estate transaction. Key coverages include:

- Loss due to fraud dishonesty or negligence of the title insurance agent, and
- Loss due to failure to comply with the closing instructions of the lender.

Often agent misconduct results in impairment of title and a direct claim under a title insurance policy. In these cases losses can be paid under both the CPL and the title policy. The CPL contract is not part of the title insurance policy and is extra-contractual to it. Usually no separate premium is paid for a CPL and because of this it is often not considered to be the business of insurance and/or subject to regulation by state insurance department officials.

The oldest and most common type of CPL is that provided to mortgage lenders, either specifically for each loan insured or on a blanket basis for all mortgages made by the lender. Mortgage lenders are important customers of title insurers and title agents. They are policyholders many times over but pay no premium. Because lenders often have influence as to the borrower’s choice of title insurer or agent, they have great influence over title insurers and have negotiated rather broad and generous CPL coverage to protect their own interest.

CPLs protecting the seller of the real estate is rare. Unlike the buyer and the buyer’s lender, the seller is not a prospective insured of the title insurance policy. Unlike lenders, sellers of real estate are often not in the real estate business and are unsophisticated in such matters and have little influence over title insurers or agents. Still, the seller is at risk from improper or illegal acts of the title agent. CPLs required by state governments in a handful of states provide viable coverage but other CPLs provided to sellers may not.

Other parties, such as real estate sales agents (who are owed a commission), surveyors, and inspectors are typically not protected by any type of CPL.

CPL Policy Forms For Buyers & Their Lenders

Unlike insurance policies, CPLs are often not filed with regulatory officials. While ALTA publishes sample CPLs there is no requirement to adhere to the ALTA provisions. Except for a few states, CPLs must be requested by the lender or buyer and they are not required to be issued. A CPL issued directly to a lender can be unique to that lender. The states vary as to regulation of CPLs:

- FL, NM, TX & MO have promulgated CPL policy forms.
- LA, NC, NJ, OH, and PA have rating bureau forms.
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

- AR, AZ and MO require that CPLs be offered under certain circumstances.
- NY prohibits CPLs.
- NH, VT, VA, and WI prohibit CPLs coverage of agent dishonesty.

Note: unless required by law, CPLs must be requested by the buyer and are provided free or low cost. This is important for consumers to know so that they can protect themselves from agent misconduct.

“Split closings”, where more than one escrow account is established, pose special problems.

The American Land Title Association (ALTA) has various versions of CPLs dated 3/27/1987, 10/17/1998, 12/11/2006 and 12/1/2011. Core coverage is similar but the terms have generally become more restrictive over time.

In a lender/buyer CPL, the title insurer promises to indemnify the lender and/or buyer for certain damages resulting from specified improper acts of the agent. CPLs protecting the lender only often inure to the benefit of the borrower.

The improper acts are (1) failure to comply with written closing instructions or (2) fraud, dishonesty or negligence. Newer ALTA CPL forms require that that the company be contractually obligated to issue title insurance and restricts coverage to improper acts that relate to the status of title.

The prospective lender provides the closing agent with a written list of closing instructions needed to process and execute the loan. Mistakes in these items can result in loss to the lender or to a loan that cannot be sold.

Dishonest acts, called defalcations, include outright embezzlement. Often funds are taken from more than one escrow account or from escrow accounts that are commingled with one another. Defalcations are typically large and often result in the bankruptcy of the agency. For the most part defalcations are perpetrated by the owner(s) or principal(s) of the title agency. When this happens, a typical fidelity bond and errors and omissions policy provides no coverage.

Simple negligence in conducting the closing, while covered under a CPL, often does not result in large losses. The title insurer’s agency contract often requires the agent to pay these types of losses, perhaps up to a certain limit. Errors and omissions policies also respond to these types of losses.

CPL Policy Forms For Sellers

Title insurers generally do not provide a seller’s CPL unless required to do so by law. Arkansas, Texas and Missouri require seller’s CPL in certain circumstances.

Texas and Missouri have promulgated seller’s CPL policy forms:
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

- Texas’ seller’s CPL form is Form T-51
  http://www.tdi.texas.gov/title/titlem5c.html#Form T-51
- Missouri’s seller’s CPL form is Form T-8
  http://insurance.mo.gov/laws/documents/FormT-82008-01-17.pdf

Warning: Some seller’s CPLs or those that are addressed to “seller, lender, buyer” provide little or no coverage to the seller. This is because the terms of the CPL require that those protected by the CPL be a party to the title insurance policy, which the seller is not.

The coverage under the seller’s CPL mirrors the agent dishonesty part of the buyer/lender CPL.

2. Public Policy Issues

[From Marty Hazen]

CPLs can protect the lender/buyer/public against losses suffered as a result of certain acts or omissions by the title insurer’s agent.

A CPL contractually provides that the title insurer will reimburse the lender/buyer named in the letter when the lender/buyer is purchasing the title insurer’s policy, for certain losses incurred under certain conditions resulting from actions or inactions by the title insurer’s agent.

These acts can include:

a) The agent’s failure to comply with written instructions with respect to status of interest in land, enforceability and priority of liens, obtaining documents specifically required, and collection/disbursement of funds at closing

b) The agent’s fraudulent or dishonest actions in handling funds or documents at closing

CPLs do not provide coverage for matters such as failure of the documents to comply with applicable laws or regulations regarding environmental land use, lender regulation or zoning.

CPLs generally cover specific transaction, though they may be issued on a blanket basis. CPLs must be requested by the lender or buyer before the closings.

Lenders most commonly request CPLs as a regular part of the closing process. Lenders may not be willing to close without a CPL.

Buyers may be protected by the CPL that their lender obtained, but this may not always be the case. Buyers may request CPLs, though they may not be aware that CPLs can be available.

CPLs may protect the public by giving them confidence in the entire closing process when they are buying a home.
CPLs can facilitate real property exchange/commerce by making lenders more willing to fund transactions that are covered by a CPL. When a lender has obtained a CPL, they may be more willing to loan money for real estate transactions then they would be without a CPL, because they may perceive that there is less risk of losing their funds. Additionally, the closing process can be handled with confidence since lenders may not have to deal with problems regarding their interest in the transaction, liens, documentation, etc.

The use of CPLs may facilitate interstate commerce. A bank may be more willing to fund a transaction in another state handled by a title agency they are not familiar with if they have a CPL from the title insurance company and know that their funds are secure and they will be compensated if their instructions are not followed in the closing and documentation.

CPLs generally do not appear to provide protection to sellers when they are issued only to the buyer and lender in a transaction. It would appear that sellers in general are unaware of CPL availability.

Conversations with the industry indicate that CPLs appear to be rarely issued to sellers, though they can be if a title company chooses to do so. Some States (like Illinois and Ohio) appear to require all parties involved in a transaction (lender, buyer/borrowers & seller) to be offered or provided a CPL.

If a seller is also the lender in a transaction, they may wish to obtain a CPL to cover their interest.

3. **Legal Issues**

[From Brett Barrett]

**OVERVIEW**

A “Closing Protection Letter” is an indemnification agreement where a title insurer indemnifies a mortgage lender or purchaser against actions of the settlement agent in connection with real estate closings. The title insurance agent, known in some states as a title insurance producer, typically fulfills two roles. The first role is as an agent of the title company in issuing a title insurance policy. The second role is during closing as a settlement agent or escrow agent. In some states the two roles are fulfilled by separate title and escrow companies. In the second role the title insurance producer owes a fiduciary duty to both the buyer and the seller of the property and is not an agent of the title company under traditional agency law. To protect against fraud and misdeeds of the escrow agent, a mortgage lender will often require the title company to issue a Closing Protection Letter to the lender.

A Closing Protection Letter typically provides protection in two situations. First, Closing Protection Letters protect against fraud, dishonesty or negligence of the settlement agent as it relates to the status of title. If the settlement agent misappropriates the money and fails to pay off a previous lien then the title company will be liable for the actions of the settlement agent.
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

Second, Closing Protection Letters protect against failure of the settlement agent to comply with the written closing instructions of the lender to the extent they relate to the status of the title. The primary function of the Closing Protection Letter is to indemnify against loss caused by the settlement agent.

STATUTORY DEFINITIONS

“Insurance”, the “business of insurance”, “insurance business”, and “title insurance” are generally defined in each state’s code. Whether a closing protection letter qualifies as insurance or title insurance is largely a matter of applying the applicable state law.

CLOSING PROTECTION LETTERS ARE PROBABLY NOT A FORM OF TITLE INSURANCE

While some state courts have no published decisions regarding Closing Protection Letters, other courts from around the country have issued rulings discussing Closing Protection Letters and their legal ramifications. Insurance contracts are held to be indemnity agreements, but indemnity agreements are not necessarily insurance contracts. Some courts imply that Closing Protection Letters are integrated into and become part of a title policy because they are typically only issued by insurers that also issue the title insurance. Other courts have found that Closing Protection Letters do not fall under their states statutory definition of title insurance. A few cases have discussed the implications Closing Protection Letters and whether they are insurance. Closing protection letters are form letters which are issued to a lender by a title/escrow company.

Most court decisions issued recently have held that Closing Protection Letters are not a form of insurance nor are they a part of the title policy. They are considered a separate indemnification agreement protecting the lender. (See Bergin Financial, Inc. v. First American Title Co. 397 Fed.Appx 119 (6th Cir. 2010) citing Ticor Title Ins. Co. v. Nat’l Abstract Agency, Inc., 2008 WL 2157046 at *5.) (See also New Freedom Mortg. Corp. v. Globe Mortg. Corp., 281 Mich.App 63 (Mich. 2008) holding that not collecting funds due to seller at closing was not sufficient to trigger the protection of a Closing Protection Letter).1

Additionally, the 6th Circuit also held that in the absence of a closing protection letter, the title/escrow company may not be liable for the closing agent’s actions. Bergin Financial, 394 Fed.Appx at 125 (holding that the closing agent was not acting under the authority of First American when a closing protection letter was not issued).

SOME COURTS HAVE HELD THAT TITLE INSURANCE POLICIES IMPLICITLY PROTECT AGAINST FRAUD OF SETTLEMENT AGENT AND THEREFORE CLOSING PROTECTION LETTERS ARE INCLUDED IN THE POLICY.

---

1Additionally, in Utah, Title Insurers are required to keep Errors and Omissions Insurance (or a bond of equal value), which may provide some of the same protections as a closing protection letter, depending on the policy terms. UCA §31A-23a-203.5
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

In two older companion cases from New Jersey, the court held that the Closing Protection Letter and the title insurance policy were integrated and were not separate policies. See Clients’ Security Fund of the Bar of New Jersey v. Security Title and Guaranty Co., 134 N.J. 358, 377 (1993); and Sears Mortgage Corp. v. Rose, 134 N.J. 326, 350-352 (1993). Additionally, in Wisconsin a court held that the arbitration clause of the title insurance policy covered a dispute arising out of a closing protection letter. Fleet Mortgage Corp v. Lynts, 885 F.Supp. 1187 (E.D. Wisc. 1995).

While most recent cases have held that Closing Protection Letters are separate from title insurance policies, there are still cases in which the Closing Protection Letter was found to be included in the title insurance policy.

CLOSING PROTECTION LETTERS DIFFER FROM STATUTORY DEFINITIONS OF TITLE INSURANCE

The courts which have held that Closing Protection Letters are not title insurance have focused on a few defining features of title insurance. First, a Closing Protection Letter’s protection is different in kind than traditional title policy protection. Second, title companies do not collect premiums for Closing Protection Letters to be placed in separate accounts to cover potential losses. Third, there is a lack of distribution of risk.

In cases in Virginia and Alabama courts found that Closing Protection Letters fall outside the state’s statutory definitions of title insurance noting that title insurance covers different risks than Closing Protection Letters. See Carstensen v. Chrisland Corp., 442 S.E.2d 660 (Va. 1994); and Metmor Financial, Inc. v. Commonwealth Land Title Ins. Co., 645 So.2d 295 (Ala. 1993). Both cases noted that title insurance protects against actions in the past, while a Closing Protection Letter protects against future actions by the settlement agents. Carstensen 442 S.E.2d 660, 665; also Metmor 645 So.2d 295, 297. In Metmor, the Alabama Supreme Court noted a lack of risk spreading and the fact that no premiums were collected or deposited into a separate fund to cover potential losses. Id. The court stated that it was “clear that the closing service letter is not a title insurance policy.” Id.

In a Florida federal district court case the court held that under the McCarran-Ferguson Act, which exempts insurance from the Sherman Antitrust Act, a Closing Protection Letter might not be insurance because of a lack of risk spreading. Escrow Disbursement Ins. Agency, Inc v. Am. Title Ins. Co., 550 F.Supp. 1192, 1197 (S.D. Fla. 1982). Another more recent case out of Georgia held that a closing protection letter is not a “policy of insurance” within the meaning of a statute making insurer liable for bad faith failure to pay covered claim. Lawyers Title Insurance Corp v. New Freedom Mortgage Corp., 655 S.E.2d 269, 275 (Ga.App. 2007). The court quoted the Georgia Supreme Court which stated that “a necessary element of insurance is distribution of risk.” Id. quoting Ponder v. Fulton-DeKalb Hosp. Auth., 256 Ga. 833, 835 (1987).

CLOSING PROTECTION LETTERS ARE GENERALLY HELD TO NOT BE PROHIBITED BY MONOLINE RESTRICTIONS
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

Companies that issue title insurance may also be restricted from selling other forms of insurance. If a Closing Protection Letter is found to be another type of insurance, such as fidelity insurance, then the title company may be in violation for offering a the Closing Protection Letter.

The two New Jersey cases cited above, Sears and Clients’ Security, discuss this issue. In Sears, the court stated that the Closing Protection Letters protection was clearly an incident to the issuance of title insurance and that the title company “cannot now claim that such coverage is impermissible.” 634 A.2d 74, 86 (N.J. 1993). In Clients’ Security, the court stated that the obligation to indemnify was “implicit in title insurance.” 634 A.2d 90, 97 (N.J. 1993). In Utah, the problem of monoline restriction is likely not an issue. The Utah Code imposes liability on title companies for the actions of title insurance producers. See U.C. § 31A-23a-407. Section 407 codifies the indemnification that Closing Protection Letters are meant to protect. It would be difficult to argue that a title company is restricted from issuing a Closing Protection Letter when the Utah Code already imposes liability.

DO CLOSING PROTECTION LETTERS PROTECT BORROWERS, OR SIMPLY LENDERS?

Generally Closing Protection Letters are utilized to protect the interests of lenders, but they could be issued to protect persons other than lenders in real estate transactions. The American Land Title Association (ALTA) Closing Protection Letter example (revised 12-1-2011) allows a lender, its assignee, a purchaser of an interest in land, or a lessee of an interest in land to be covered. The language in the ALTA example appears to exclude certain parties from coverage, including sellers of real estate and borrowers in a refinance. However, this is only one example of a Closing Protection Letter and others could, in theory, allow for borrower protection. At least one state, Missouri, requires a separate Closing Protection Letter to be issued to both the buyer and seller in a real estate transaction. Closing Protection Letters are generally not automatically issued, and are typically only issued at closing when requested by the lender. While it seems logical to charge for additional indemnification, it may be unfair to charge the borrower/buyer when he or she isn’t the one explicitly and solely receiving the protection of a Closing Protection Letter.

CONCLUSION

As can be seen from the foregoing cases, the law surrounding closing protection letters is not clear. Some courts have found that the protections afforded by the closing protection letter are integrated into the title policy or already a part of the policy. Other courts have found that the closing protection letter is not a title policy and that it protects against different risks. Standing alone, the closing protection letter likely does not fall under Utah’s definition of “title insurance” because it does not protect against loss “by reason of liens or encumbrances upon, defects in, or the unmarketability of the title to the property, or invalidity or unenforceability of any liens or encumbrances on the property.” The letter protects against fraud or failure to follow closing instructions. Standing alone the closing protection letter likely would be considered “fidelity insurance” but as it is only provided in conjunction with issuance of a companion title policy it should not be viewed in isolation. The fact remains, though, that the protections afforded in a Closing Protection Letter are different in kind from the protections of a title policy and a Closing
Protection Letter does not fall under the statutory definition of title insurance. As such a Closing Protection Letter is likely not title insurance.

The NAIC Title Insurers Act contains provisions, in Section 6, which permit title insurers to issue closing or settlement protection if not contrary to existing laws. The provisions only permit such closing or settlement protection for actions of the insurer’s named agent and prohibit the insurer from providing coverage which purports to indemnify against any other improper actions.

Some regulators have expressed the opinion that any premium charged for closing protection letters should be remitted in full to the underwriting carrier and that appropriate reserves must be established for the coverage. At least one consumer advocate expressed the opinion that lenders who require such coverage could pay the CPL premium rather than the real estate buyer.

[Other possible topics to address]
- Closing protection letters
- Errors and omissions coverage
- Prefunded guarantee funds
- Enforcement and criminal prosecution of those that steal escrow funds
- Consider updating insurer solvency standards (SPR)
- Underwriter liability and strict liability

Underwriter liability and strict liability

A few states have adopted requirements that hold title insurers responsible for the escrow and settlement activities of their appointed agents. An example of such language, located in the Nebraska Title Insurers Act follows:

“A title insurer is liable for the defalcation, conversion, or misappropriation by a title insurance agent appointed by or under written contract with such title insurer of escrow, settlement, closing, or security deposit funds handled by such title insurance agent in contemplation of or in conjunction with the issuance of a title insurance commitment or title insurance policy by such title insurer. However, if no such title insurance commitment or title insurance policy was issued, each title insurer which appointed or maintained a written contract with such title insurance agent at the time of the discovery of the defalcation, conversion, or misappropriation shares in the liability for the defalcation, conversion, or misappropriation in the same proportion that the premium remitted to the title insurer by such title insurance agent during the twelve-month period immediately preceding the date of the discovery of the defalcation, conversion, or misappropriation bears to the total premium remitted to all title insurers by such title insurance agent during the twelve-month period immediately preceding the date of the discovery of the defalcation, conversion, or misappropriation.”

This stricter standard of liability placed on title insurers can provide incentive for more thorough insurer audits of its agents, and more thorough and quick resolution of problems that might arise. However, title insurers point out that widespread use of such requirements could be unsustainable at current or similar premium levels. This standard can also add barriers for small
or new title agencies obtaining contracts with title insurers. Such requirements seem to be more acceptable in jurisdictions where problems are less prevalent or where transactional volume is low. Additionally, not all closing and settlement activities are performed by agents that are affiliated with the title insurer.

Software and Information Technology Solutions

In recent years, insurers and IT Vendors have developed integrated software solutions that offer real-time interaction between title insurers and title insurance agents. Solutions that integrate such title and escrow activities as policy orders, policy and endorsement issuance, search functions, accounting and administration of escrow and settlement funds can help reduce administrative costs for title insurance agents, improve record retention, reduce inadvertent mishandling of funds and provide a less expensive method for insurers to audit and oversee activities of title insurance agents.

Enhanced Regulatory Oversight

In most jurisdictions, title insurance business makes up a relatively small proportion of the total business of insurance in the state. When problems such as a defalcation emerge, however, the time and resources for dealing with the aftermath can be staggering. It is important that regulators remain diligent in their duties to oversee this line of business. Important measures that can be taken include:

• Making best efforts to promote sound and strong title insurance laws and regulations within the jurisdiction
• Having sufficient staff persons who are trained and knowledgeable about the intricacies of title insurance and settlement services
• Maintaining an open channel of communication with title insurers, title insurance agents and applicable associations
• Maintaining a reasonable and visible schedule for conducting examinations or other types of oversight activities of both title insurers and title insurance agents
• Identify and address potential gaps in regulation of entities that may perform closing services
• Having a clear plan of action on how to respond to cases of defalcation. In addition to assisting with remediation for customers, regulators should be prepared to coordinate or make referrals to applicable law enforcement for subsequent action if warranted.
IV. Conclusions/Recommendations